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SIPDIS

DEPT FOR EUR/RUS, FOR EEB/ESC/IEC GALLOGLY AND WRIGHT, FOR
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DOC FOR JJBROUGHER
NSC FOR MMCFAUL, JELLISON

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TAGS: [EPET](#) [ENRG](#) [ECON](#) [PREL](#) [RS](#)

SUBJECT: VISIT OF SE MORNINGSTAR: RUSSIA RECEPTIVE TO
DIALOGUE; URGES CONSORTIUM TO MANAGE UKRAINE PIPELINES

Classified By: DCM Eric S. Rubin for Reasons 1.4 (b/d)

SUMMARY

¶1. (C) In June 17-18 meetings with visiting Special Envoy for Eurasian Energy Morningstar, Russian interlocutors welcomed greater cooperation and dialogue with the U.S., including on two-way investment and global strategic issues such as the future of LNG, pipelines, and energy diplomacy. SE Morningstar made clear that we neither oppose nor support either the proposed Nord Stream or South Stream pipelines; that these are primarily European issues. He noted that some countries support and some oppose the pipelines, but that concerns about the pipelines should be addressed. He also stressed that Nabucco does not threaten Russia's role as the dominant supplier of imported gas for Europe. On Ukraine, Russian Deputy Foreign Minister Denisov, Energy Minister Shmatko, Presidential Special Representative for International Energy Cooperation Yusufov, and Gazprom Deputy CEO Alexander Medvedev all had the same central talking point -- that the Ukrainian gas system needs to be managed by a European-Russian consortium that could invest in upgrading and modernizing it in order to ensure uninterrupted flows of gas to Europe. In a group dinner, representatives of Western oil and gas companies told SE Morningstar that their main concerns in Russia were a tax system based on revenues rather than profits and a regulatory framework that hindered foreign investments in exploration and production. End summary.

COOPERATION AND DIALOGUE WELCOME

¶2. (C) In separate June 17 - 18 meetings with Energy Minister Shmatko, Deputy Foreign Minister Denisov, Presidential Special Representative for International Energy Cooperation Yusufov, Gazprom Deputy CEO Alexander Medvedev, and Lukoil Executive Vice President Maganov, visiting Special Envoy Morningstar explained that we are interested in pursuing dialogue and cooperation with the GOR and Russian entities on a variety of broad issues of mutual interest. All Russian counterparts welcomed this prospect. SE Morningstar suggested that the energy policy sub-group of the proposed Bi-National Commission (BNC) Energy Working Group could discuss ways to increase two-way investment in the energy sector and explore avenues for U.S.-Russian cooperation in third countries as well. He said the two-sides could also

discuss broader strategic issues such as the future of LNG, governance, and international pipelines.

13. (C) Energy Minister Shmatko agreed that a strengthened bilateral dialogue would be important and noted his positive discussions with Secretary Chu on technological cooperation. Shmatko had a long list of potential issues for discussion under the BNC, including Central Asia, the growing role of East Asia, the Arctic, and energy efficiency. On energy policy, Shmatko said he believed we should identify ways to harmonize our policies on energy sector investments. He suggested a "quid pro quo approach -- we give access to U.S. companies and you give access to our companies." He cited the Lukoil-ConocoPhillips partnership as a model, but emphasized that we should not restrict our cooperation to that model. Shmatko said we need a forum to discuss global issues, including energy transit. He embraced an expanded role for LNG in the gas trade as a means of "eradicating political risk." He added that bilateral talks would also help each side clarify what third parties are telling us independently.

14. (C) DFM Denisov said he believed Russia and the U.S. are "natural allies" on energy issues. He said the potential for cooperation is great but, quoting Mao, added, "prospects are bright, but the road is winding." Denisov said the MFA's role will be to "look after the political and diplomatic matters related to energy" in order to facilitate such cooperation, and that the MFA might provide SE Morningstar's counterpart in the BNC sub-group. Denisov also welcomed the prospect of greater Russian investment in the U.S. energy

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market, and, like Shmatko, pointed to Lukoil-ConocoPhillips cooperation, including in Iraq, as a successful model of partnership.

15. (C) Lukoil's Maganov stressed that mutual respect and a goal of mutual benefit is the best approach to working successfully in any foreign country. Maganov praised the Lukoil partnership with ConocoPhillips as exemplifying this approach. He complained that the approach of Western companies in Russia in the 90s was one of "we'll teach you how to do it right," and that this approach did not sit well with Russian counterparts.

16. (C) Special Representative Yusufov focused on the prospect of LNG from the giant Shtokman gas field as a key to closer future U.S.-Russian cooperation. He stressed that even without production sharing agreements, there is plenty of scope for U.S. participation in Russia, including in Shtokman. He said "internal problems with the Shtokman project will compel management to look for additional partners," and added that the U.S. will be the main market for Shtokman gas. He stressed that the U.S. market, for both oil and gas, is key for Russia, and that "our cooperation could rest on this."

17. (C) Gazprom's Alexander Medvedev said it was "important to overcome the misunderstandings of the past" and find ways to cooperate. Echoing Yusufov, he said the target for Shtokman gas is the North American market and that Gazprom was looking to collaborate with a U.S. company to make such deliveries possible. Medvedev stuck to Gazprom's public claim that gas from Shtokman would be available by 2013, but only "if a final investment decision is made by March 2010."

PIPELINES

18. (C) SE Morningstar made clear to all his Russian interlocutors that we neither oppose nor support either the Nord Stream or the South Stream gas pipelines. He noted that some European countries support these pipelines and some have issues which should be resolved. Noting that Russia's

dominance of the European gas import market will not be threatened, SE Morningstar also stressed that Russia should not be concerned about the Nabucco gas pipeline, and suggested Russia consider bidding on supplying the pipeline with gas given that 50% is available for outside bid. SE Morningstar explained that pipeline politics have muddled the reality that the fate of any pipeline ultimately rests on commercial realities.

¶9. (C) Noting that even a "pessimistic" forecast for European gas demand calls for 100 bcm of additional imports by 2025 due to dropping domestic production, Medvedev declared "all projects should go forward." He added that Gazprom does not see Nabucco as a competitor, but that Gazprom is "not sure" about its ability to provide gas for the pipeline. He said "if it gets off the ground, we would likely participate.⁸ On South Stream, Medvedev claimed the pipeline is cheaper for Gazprom than going through Turkey.

¶10. (C) SE Morningstar's official interlocutors did not comment at length on pipeline specifics. Energy Minister Shmatko only noted that Nabucco would represent just 5% of European gas imports, to which SE Morningstar responded "so why worry?" He also noted that if there was anything to worry about, it would be what China is doing in Central Asia. Shmatko added that Russia's plans for "sea routes" are based on minimizing the "number of players" involved in the energy trade.

¶11. (C) Nord Stream executives welcomed the "clarification" on the USG position on their pipeline. They said the pipeline is on schedule, but admitted that financing has been "much more difficult" than expected. They said they believe South Stream would also be built, but suggested the project was about 5 years behind theirs.

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UKRAINE

¶12. (C) All of SE Morningstar's counterparts had much to say about Ukraine. Medvedev went into greatest detail, saying Gazprom was "very worried" time may have already run out for Ukraine to adequately fill its storage facilities and ensure uninterrupted flows to Europe in winter. He explained that only one-third of Gazprom's winter exports to Europe are direct. The other two-thirds, he said, are "swaps," with Gazprom supplying gas to Ukraine and Ukraine sending gas to Europe from storage. According to Medvedev, "there is literally not enough capacity in the transit pipeline for Russia to directly supply Europe's needs in winter." He added that Gazprom estimates that Ukraine currently needs 16 bcm of additional gas to fill its storage facilities and that a maximum of 2.7 bcm a month can be pumped into storage. He also said that Gazprom has continued to allow EU monitoring of its dispatch center, but that Ukraine had ended this access (a point EU Ambassador Franco had earlier made to Ambassador Beyrle).

¶13. (C) Medvedev complained that Europe has not done enough to resolve the Ukraine transit problem, instead telling Gazprom that the problem is Gazprom's to solve. He then described Gazprom's frustrations in dealing with Ukrainian counterparts, who he accused of being inconsistent and untrustworthy. Saying that Ukraine will continue to be a problem because "it has gotten away with it in the past," he compared Ukraine to a child -- "if you're not punished in kindergarten, you will not learn to behave."

¶14. (C) Medvedev said Ukraine needs a European-Russian consortium to "manage" its pipeline system and to provide the capital to modernize and upgrade it. He said Gazprom "is ready to play any role to help facilitate" a resolution to the Ukraine transit issue, and that Gazprom's interest has

nothing to do with a desire to own the Ukraine's gas transportation network. Without irony, he followed that statement by pointing to Armenia and Belarus as models of successful resolution of the payment recurring payment problem because "they decided to sell their assets to make their payments."

¶15. (C) All other Russian interlocutors, including Lukoil's Maganov, as if having received the same talking point, stressed the same on Ukraine -- the need for a European-Russian consortium to take over the pipelines. There was some disagreement in their messages, however, on how we should approach the issue. Shmatko, blaming Ukraine and claiming Russia is only interested in respect for contracts, said the Ukraine situation has become "lose-lose." He expressed his hope that Europe and the U.S. would "use their influence" with the international financial institutions to help Ukraine reform itself. Denisov, on the other hand, specifically referred to the Ukraine problem as a "family quarrel." He said Russia can "argue and be tough" with Ukraine, but that at the end of the day, the two sides are still family.

CENTRAL ASIA

¶16. (C) Relations with Central Asia were also briefly discussed during several meetings, with Shmatko suggesting inclusion of this topic under the BNC. DFM Denisov said Russia is very active with its Caspian partners, but that bilateral interaction has been more productive than multilateral interaction. Maganov said Lukoil is working with ConocoPhillips in Turkmenistan (offshore oil and gas), and was recently ready to sign a contract, but it "was suddenly stopped" by the Turkmen side.

¶17. (C) For his part, SE Morningstar emphasized that U.S. activities in Central Asia pale in comparison to those of the Chinese, who will soon have large volumes of Central Asian oil and gas flowing east. Apparently forgetting that Russia, the current de-facto monopsony consumer of Turkmen gas recently cutoff its purchases from the country, Yusuf

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commented that Turkmenistan should not want to be beholden to China as a monopsony buyer.

IRAN

¶18. (C) Commenting on the turmoil in Iran, DFM Denisov said Russia "more dislikes than likes" Ahmadinejad, but sees him as "at least predictable." He said Russia simply does not know as much about Moussavi. Denisov added that, in his view, "Iran belongs to the U.S. in the long-run," noting that only the U.S. will have the capability to provide the huge investments the country needs to modernize. On Iranian gas sales to Europe, Denisov said he did not believe Iran would be willing to send gas through Turkey, which it sees as a regional competitor to its leadership. He said he believes the more likely route for Iranian gas exports is via LNG and to India.

IOC PRIORITIES

¶19. (C) SE Morningstar met collectively with representatives of ExxonMobil, Chevron, ConocoPhillips, Shell, and BP. The representatives emphasized their interest in investing in Russia for the long-term, assuming the investment climate develops appropriately. They had two main concerns: the revenues-based (as opposed to profits-based) tax system and the separation of exploration and production licenses. The

tax structure, they said, discourages the type of long-term and large greenfield investments Russia needs. The separation of exploration and production licenses, they added, discourages exploration because it does not guarantee production rights if a large field is found. They said Russian production of oil and gas would soon decline without appropriate reforms to the investment regime.

¶20. (U) SE Morningstar has cleared this cable.
BEYRLE